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PRICE FIXING IN A COMPETITIVE INDUSTRY: A PIONEER CASE¹

In the field of public utility valuation and rate regulation, both precedent and literature are abundant. Such is not the case with regard to valuation and prices in the field of the ordinary "industrial" corporations. That a United States Circuit Court should have passed on the question of a fair and just maximum price for a commodity produced by competing industrial corporations is, therefore, of considerable interest; and the fact that the action was not taken by the price fixing committee or any other body exercising war powers, heightens the significance of the case for the economic student of normal industrial life. The circumstances are as follows:

In 1916 the Federal Trade Commission conducted an investigation of the news print paper manufacturing industry. As one result of that investigation, the commission was convinced of the desirability of establishing reasonable and stable prices for news print paper, and endeavored to arrange for such prices by agreement with the manufacturers. While negotiations looking toward voluntary coöperation were under way, however, the Federal Grand Jury for the Second District of New York brought indictments against several leading manufacturers, whereupon negotiations with the commission were broken off (May, 1917). What took place thereafter is not known to the writer; but on November 26, 1917, the Attorney General of the United States entered into an agreement with the manufacturers, which provided for the price fixing here to be described. It appears that by agreement several of the indicted parties entered pleas of *nolo contendere* and paid fines. According to the agreement between the Attorney General of the United States, as trustee, and certain persons and corporations engaged in the manufacture and sale of news print paper, the Federal Trade Commission was to fix the maximum prices and terms of sale of the output of the news print paper of ten companies. Such prices and terms of sale were to apply on purchases in the United States for the duration of the war and three months thereafter.

Accordingly all parties in interest were invited to lay before

¹ The writer does not intend by anything which follows to argue for price fixing, but merely to throw light on what has been and may be done *if* prices are fixed.

the commission any pertinent data, and extensive hearings were held at which a great mass of evidence was taken. Cost figures were drawn from the books of original entry, and the vouchers of accounts of the ten manufacturers were scrutinized by expert accountants. Complete appraisals of various plants were also presented. On June 18, 1918, the commission released for publication its findings concerning reasonable maximum prices as of April 1, 1918, the main item in which findings was that a price of \$3.10 per hundred pounds f.o.b. mill should apply on roll news print paper in carload lots.

Unfortunately the commission in its published findings did not present a full statement of the grounds upon which its decision was based. The only points of interest to be gleaned from them are: (1) income and excess profits taxes, whether individual or corporate, were eliminated from cost; (2) the cost of a small and incomplete mill was "not allowed to control in the determination" of the prices fixed; (3) the commission endeavored to allow a just and reasonable profit "based on the value of the property employed and the circumstances surrounding the industry"; (4) the commission sought to determine a price which would be the same "as though fixed by the seller," which presumably means that it desired to arrive at a price similar to what would have prevailed under normal competitive conditions; (5) the commission's decision took account of the important distinction between valuation for sale and valuation for rate making, and explicitly rested upon the assumption that the case in hand was one in which the purpose was to fix a rate for a going concern; (6) though not explicitly stated, the commission in reasoning concerning investment based its conclusions upon an average investment necessary for an efficient mill.

The commission's findings were not satisfactory to the manufacturers of news print paper, and, as provided for in the agreement with the Attorney General, they promptly took the matter before the United States Circuit Court for the Second District for arbitration. Their case is set forth in a printed brief, which contains arguments of considerable interest:

1. Counsel for the manufacturers cites several decisions in cases involving valuation and rate making for public utility corporations. It is noteworthy, however, that these cases are cited with the idea that they should apply on valuation only, and not upon the rate of return upon investment.

2. As to cost, the chief contentions of the manufacturers appear to be: (a) that they prefer not to have their woodlands included as a part of their investments, but to charge the quantity of wood used in the manufacture of news print paper into their expense accounts; and that such charges to expense should be at the market value of wood, rather than at cost to the manufacturer; (b) they criticize the commission for basing its findings upon the costs as ascertained for the early months of 1918, without making allowances for increases in costs occurring between that period and the date when the prices were to take effect, and they contend especially for an increase of 35 per cent in the cost of wood, as that item was taken into the commission's findings; (c) they protest against basing the price upon an average cost, contending apparently that the highest cost should be taken as a basis.

3. Perhaps the chief contentions of the manufacturers concerned the investment figure. (a) In the first place, they accepted the cost of reproduction basis, and emphasized the cost of two particular mills which had been built, in part at least, since the war. The figures for these mills they supplemented by recent appraisals of the other mills concerned. (b) In the second place, they claimed a large allowance for "going value," advancing testimony of experts to the effect that "going value should be allowed, and should be determined by taking approximately 17 per cent of the value of "tangibles" (plant, equipment, etc.). (c) Finally the manufacturers made claims for a large percentage of return upon investment, their figure being from 18 to 20 per cent. Such claims it will be noted were not based upon decisions in public utility cases, nor even upon returns which the news print paper manufacturers had been getting in the past, but rather upon testimony of "experts," as to what they ought to get, and upon general reasoning concerning the risks of the industry. The figures claimed by the manufacturers for reasonable valuation per daily ton of capacity were:

News print paper plant and water power development..	\$27,500
Going value	4,675
Working capital	12,000
	<hr/>
Total	\$44,175

On their part, the newspaper publishers also submitted a brief, the salient features of which were the following:

1. A news print paper manufacturing mill is not a public utility, and the principles set forth in public utility cases do not apply.

2. The costs presented by the manufacturers, and to some extent those found by the commission, included several items which should not be allowed. For example, the publishers point out that in the case of several companies the costs contained items of extraordinary expense, either not applicable to the period during which the price fixing would apply, or representing abnormal operating conditions. Thus, one company's costs included purchased paper (finished product) and others included winter handling of wood. Several of the companies included considerable items of legal expenses which applied to the defense of their interests in the suit brought by the Attorney General under the federal anti-trust laws. Again, in some cases the costs included items which apparently were excessive, being in the nature of estimates, which not unnaturally were made large enough to cover all possibilities. Such items were those for loss in "sinkage" and barking of logs, and losses in manufacture. Probably the most important contention of the newspaper publishers, however, concerned the inclusion in cost of inter-company or inter-departmental profits. All the manufacturers appear to have included stumpage charges covering the value of timber cut. In some cases the stumpage charges were made even when the company did not own the timber, but merely had certain rights to cut timber. In all cases charges were based on the market value of wood rather than on the actual cost to the company of producing the wood. This necessarily had the result that the so-called wood cost involved in manufacturing news print paper, was larger than the actual cost by the amount of the profit made by those whose sales of wood figured in the making of the market.

With regard to investment, the publishers contended that it should not be based upon war prices of the materials needed for constructing a paper mill, and that if cost of reproduction was to be taken as the basis for determining investment the costs should be as of the period immediately preceding the war. They further contended that "going value" should not be included in investment, nor did they believe that the manufacturers could really have earned 18 per cent on their investments under normal competitive conditions. For example, even on the basis claimed by the manufacturers, the International Paper Company, they stated,

would make a margin of \$18 per ton, while during the past twenty years it had actually earned on the average not over \$3 per ton. On the basis of the price fixed by the commission, the publishers claimed that this company would make \$10, which appeared to them to be very liberal treatment.

On September 25, 1918, the United States Circuit Court for the Second District, acting as arbitrator, handed down its findings and conclusions in the matter of the selling price of news print paper and terms of contract for the sale thereof. It is deeply to be regretted that the court did not make public a more fully reasoned opinion, setting forth in greater detail the bases for their findings. Nevertheless, a careful examination of the findings reveals points of no little interest. The chief of these appear to be:

1. "The principles applied by courts of authority in regulating rates for public utilities, should be followed in this proceeding as nearly as possible." Although the closing words of this dictum might be called "weasel words," it seems that the court was influenced by the claims of the manufacturers in this matter, and tended to overlook the distinction which undoubtedly exists between the competing manufacturers of news print paper and a municipal street railway or gas plant.

2. The court decides that the capital investment is equal the "present value" of the property actually used in paper production; and that "present value" is equivalent to "fair present value, as depreciated and at pre-war prices."

3. "Going value" is allowed by the court as a part of the necessary investment, but instead of allowing the percentage claimed by the manufacturers, the court takes 10 per cent of the tangibles in determining its amount.

4. Apparently the contention of the manufacturers that stumpage be taken into cost at market value is accepted by the court.

5. The court takes an average as the basis for its decision, both as to cost and as to investment.

6. In the judgment of the court, it is not necessary that the maximum price should be sufficient to allow a profit to those companies which are operating under abnormally difficult conditions.

7. It is decided that a fair maximum return on the capital invested in a business having the hazards which characterize the news print paper manufacturing industry is 15 per cent per annum.

The result of applying the foregoing principles is that the

court makes the following finding, with regard to investment per ton of daily capacity, which it will be interesting to compare with the claims of the manufacturers:

Tangibles	\$25,000
Going value (10 per cent).....	2,500
Working capital	12,000
Total	<hr/> \$39,500

Adding an allowance of 15 per cent, which is taken to be the fair annual return, the court arrives at a price on roll news print paper in carload lots f. o. b. mill of \$3.50 per hundredweight—40 cents higher than the Federal Trade Commission's price.

Thus, as is usual in arbitration, the final figure arrived at is somewhere between the contentions of the two parties in interest. The price fixed by the court is higher than that determined upon by the Federal Trade Commission, and lower than that contended for by the manufacturers. On the whole, however, the court may be said to have been impressed by the arguments of the manufacturers in questions of principle, particularly in the matter of investment; for it accepts the idea of a condemnation or sale value, takes the cost of reproduction as of the present time (depreciated), and includes going value. Also it includes the market value of stumpage in the cost of production, excepting only when the stumpage is not owned but is cut from leased lands.

Certain general conclusions and criticisms may now be reached. From the general tenor and language of the findings adopted by the court in this case, the following presumptions concerning the tendency of courts in future cases—if any arise—appear to be justified:

1. The costs of plants operating under abnormal or extraordinary conditions of inefficiency will not be considered.

2. The tendency will be to base conclusions upon the average cost of the several companies concerned.

3. There will be a tendency to charge raw materials into cost at their estimated market value, rather than at their cost of production; this will apply at least in cases in which the raw materials are in the nature of wasting assets, such as timber and ores. Along with this tendency goes the related tendency not to include the source of the raw materials (land) in the investment. These tendencies, perhaps, result from an attempt to put producers operating with different degrees of integration on the same footing.

4. The principle of an average investment required for a reasonably efficient plant appears to be firmly established.

5. It is noteworthy that, in spite of strong arguments to the contrary, the court in this case includes "going value" in investment.

6. The tendency appears to be towards taking "present value" as the basis for determining investment. This it will be observed is proceeding as though all valuation cases, even though the purpose is only rate regulation, involved condemnation or sale. The inclusion of going value in the investment is a corollary of this tendency.

7. There will be a determination of the degree of hazard in each industry, and the rate of return to be allowed on investment will vary accordingly.

8. Judicial reasoning in cases like that involved in the determination of a fair price for news print paper is not yet clarified, and shows important inconsistencies and confusion of thought.

To the writer's mind, the chief criticisms of the findings of the court in this case are: (1) no consideration is given to the idea of marginal cost; (2) no clear distinction is made between cost and value; and (3) the difference between a public utility corporation and an ordinary competitive business is not understood. These three points are worthy of further discussion.

By failing to recognize a range of costs, and to determine the marginal cost, the court has been unable to follow a clear-cut and logical program. It has arrived at a result which appears to be fairly accurate, by a wrong way. Taking improper items into its determination of investment and of cost, it has unconsciously endeavored to offset the excessive price which would have resulted, by adopting the average cost as a basis. The writer would submit that, if prices are to be fixed, the only correct principle is to ascertain the range of actual costs determined according to strictly correct economic and accounting principles; and then to determine what the marginal cost is, according to the production which it is desired to secure.

The confusion between the idea of cost and the idea of value appears both in the determination of cost and in the determination of investment. It is well illustrated by the inclusion of stumpage in cost at its market value. Obviously if the market value of logs is greater than the cost of producing the logs there is a profit included in such market value. Therefore, for a company which

produces its own logs, market value is not cost, but cost *plus profit*. It is easily conceivable that a company might show a loss on its total business if costs were secured in this way, while in reality making a handsome profit on the conversion of raw materials which it owned. If the stumpage is not taken at cost, the paper making company is considered as being in the wood selling business; but if it were to go out of the paper making business, there would be no market for its wood. Surely it is clear that a news print paper manufacturing company, regarded as a single integrated concern, should have its total investment, including woodlands owned in fee, treated as a unit; and that all items entering into the production of news print paper should be charged at cost, if the true net earnings attributable to the company's production of news print paper are to be ascertained.

Some inconsistency appears in the court's reasoning, in that it does not allow a stumpage charge when the timber is taken from leased land, and this for the reason that there has been no "actual disbursement." In this case, one cannot help asking what the fact of actual disbursement (cost) has to do with the matter, if the question is but one of market value.

The manufacturers, in their brief, supported their claims for the inclusion of the market value of their stumpage in cost by references to the case of *Doyle vs. Mitchell Brothers Company* (247 U.S. 179), and it may be that the court was influenced by this decision. However that may be, a close reading of the decision referred to makes it clear that it has no application, except in matters of taxation. The case of *Doyle vs. Mitchell* arose under the Corporation Tax act of August 6, 1909; and the problem of the court was to construe the terms of that act. The question before the court was to ascertain the taxable income arising during the period after the tax law went into effect, and the court itself stated that "the object is to distinguish capital previously existing from income taxable under the act."

The economist will be interested in detecting in this question between market value and cost the idea of "opportunity cost." The inclusion of market value in cost is clearly based upon the idea that a paper manufacturer has the opportunity of selling his stumpage. The fallacy of this reasoning, however, is apparent when it is observed that the attractiveness of the alternative is not an absolute fact, but depends upon the amount of the margin between the *market price* and cost.

In adopting the idea of "present value" as determining investment, the court tends to cut away from original investment and again falls into confusion between value and cost. Cost of reproduction is largely relied upon as a basis for determining this so-called present value; but the cost of reproduction as used is not actual cost. On the one hand the court adds an allowance for "going value" which does not represent investment at all; while on the other hand it includes "any investment by way of actual payment for power rights." The result is a hodge-podge of items which gives neither the amount of money actually put into the business by the owners nor the market value of the business.

The writer would briefly submit that the basis which should determine is the actual amount of the investment in the business, to the extent that the investment has been honestly and wisely made, and that such terms as goodwill and going value, unless actually paid for, should accordingly not be allowed. To defend this statement of the case in detail would obviously require too much space for present purposes.

Finally, the court does not fully appreciate the significance of the public utility concept. In its second finding it says: "The principles applied by courts of authority in regulating rates for public utilities, should be allowed in this proceeding as nearly as possible." In finding No. 11, however, it contends that drought and sabotage are "business accidents, which would not relieve them from the competition of more fortunate rivals in ordinary times," and accordingly excludes the costs of certain companies from consideration. It is submitted that in a business in which there are numerous competitors, each subject to the ups and downs of competition, the principles applied in the valuation of public utilities cannot be used. A public utility, by its very nature, is a monopoly (a fact which is expressed in its possession of a franchise) and furnishes a product which has a special and vital essentiality to the people of the community served. These characteristics do not apply to the manufacture of news print paper. This product does not have to be used in connection with the plant. The business has been at times highly competitive, and is not naturally monopolistic. It might even be contended that the people could get along without news print paper for a long time; and certainly a very much smaller quantity would answer all essential purposes. Each public utility concern is assumed to be so essential to the community which it serves that its existence in its

present state must be preserved, and the essence of the public utility valuation cases is the determination of such a reasonable investment and such reasonable rates thereon as will enable the company to survive under conditions reasonably satisfactory to the owners. In the case of the news print paper manufacturers, the essence of the problem should have been to have determined the actual investment in the reasonably efficient company and to have fixed such a rate of return thereon as would enable efficient companies to survive under competition and at the same time insure that inefficient companies would not survive.

In any case, it is apparent that the court has been inconsistent in applying the public utility idea only to investment and cost, while allowing prices to be fixed with regard to the hazard of the business.

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